

Public interest law firm; fee sharing agreements. A public interest law firm will no longer be recognized as exempt under section 501(c)(3) of the Code after it enters into a fee-sharing arrangement with a private attorney who will keep the portion of any court-awarded fee that exceeds the amount the firm has paid to the private attorney for services rendered on the particular case.

Advice has been requested whether a public interest law firm which has been recognized as exempt under section 501(c)(3) of the Internal Revenue Code of 1954 will continue to be recognized as exempt if it enters into fee-sharing agreements of the type described below.

The organization is similar to the one described in Rev. Rul. 75-74, 1975-1 C.B. 152, and has been operated in conformity with the guidelines set forth in Rev. Proc. 71-39, 1971-2 C.B. 575, and Rev. Proc. 75-13, 1975-1 C.B. 662.

In the past, the organization's public interest legal work has been handled by its own staff of attorneys who are compensated on a straight salary basis. However, the organization has indicated that, although its staff attorneys will continue to handle most of the cases undertaken by the firm, it proposes, in certain circumstances, to retain the services of private attorneys to assist its staff. This usually will occur in complicated legal actions requiring the specific expertise of a private attorney, or in cases where the proximity of a private attorney to the city where a legal action is brought would prove advantageous.

In situations requiring the employment of a private attorney, the organization proposes to enter into an agreement whereby the attorney will be paid a certain hourly rate for the services rendered in connection with the particular legal action. In addition, the agreement will provide that if a court awards attorneys' fees in the case the organization will be reimbursed for the amount it paid to the private attorney, and the private attorney will keep any excess.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable purposes.

Rev. Rul. 75-74 holds that organizations organized and operated as public interest law firms, in accordance with the guidelines set forth in Rev. Proc. 71-39 and Rev. Proc. 75-13, qualify for exemption from Federal income tax under section 501(c)(3) of the Code. These organizations benefit the community as a whole by providing legal representation on issues of significant public interest where such representation is not ordinarily provided by traditional private law firms. The key factor distinguishing the work of public interest law firms from that of private firms is that the cases handled by the public

interest law firms would not be economically feasible for the private firms.

Rev. Proc. 75-13 sets forth guidelines explaining the extent to which a public interest law firm may accept fees for its services. While that Revenue Procedure indicates that a public interest law firm may, under certain circumstances, accept court awarded fees, it specifically states that the public interest law firm must not use the likelihood or probability of a fee award as a consideration in its selection of cases. The Revenue Procedure also states that all fee awards must be paid to the organization rather than its staff attorneys and that the organization must compensate its attorneys on a straight salary basis.

Rev. Rul. 75-76, 1975-1 C.B. 154 holds that a public interest law firm's policy of accepting only fees awarded or approved by a court or an administrative agency and paid by an opposing party will not adversely affect its exempt status under section 501(c)(3) of the Code.

The requirement with respect to compensation of staff attorneys on a straight salary basis is based upon the fact that any other method of compensation could influence the public interest law firm's selection of cases. If the compensation of staff attorneys were dependent upon the number and size of the fee awards received by the firm, there would be an incentive for the attorneys to urge the selection of cases where there is a significant possibility of an awarded fee. As stated in Rev. Rul. 75-76, a public interest law firm may accept awarded fees only if it is clear that neither the expectation nor the possibility, however remote, of an award of fees is a substantial motivating factor in the selection of cases. This prerequisite to exempt status could not be clearly established where a public interest law firm compensated its staff on other than a straight salary basis.

Although Rev. Proc. 75-13 is specifically addressed only to the problem of how a public interest law firm may compensate its staff attorneys and other employees, the guidelines set forth therein are equally applicable where a public interest law firm retains the services of a private attorney to assist it in a given case. Fee-sharing or variable compensation agreements with private attorneys may also prove a motivating factor in the case selection process, causing it to accept cases where there is a substantial possibility of receiving an award fee.

In the instant case, the public interest law firm's proposal to retain the services of private attorneys to assist it in particular cases would not, in itself, jeopardize the organization's exempt status. If the private attorneys are compensated on a fixed fee or salary basis, their employment is not inconsistent with the firm's exempt status. However, the compensation of private attorneys on the basis of fee-sharing agreements of the type described above is inconsistent with the

guidelines set forth in Rev. Proc. 75-13 and with the principle that the possibility of a fee award is not an appropriate consideration in the case selection process.

Accordingly, it is held that if the subject organization retains the services of private attorneys under agreements of the type described, it will no longer be recognized as exempt from Federal income tax under section 501(c)(3) of the Code.